Docket Nos. 98-0252/0335 (Consol.)
Staff Exhibit. 1.0

DIRECT TESTIMONY

OF

JEFFREY H. HOAGG

TELECOMMUNICATIONS DIVISION

ILLINOIS COMMERCE COMMISSION

AMERITECH ILLINOIS
DOCKET NOS. 98-0252/0335 (CONSOL.)

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TABLE OF CONTENTS

Q. **Please state your name and business address.**

A. My name is Jeffrey Hoagg and my business address is 527 East Capitol Avenue, Springfield, Illinois 62701.

Q. **By whom are you employed and in what capacity?**

A. I am employed by the Illinois Commerce Commission as Director of Policy in the Telecommunications Division.

Q. **Please describe briefly your educational background and work experience.**

A. I graduated from Cornell University with a Master of Arts in Economics in 1986. I was admitted to doctoral candidacy at Cornell and completed all requirements for the Ph.D. in Economics except completion of the dissertation. My major field of graduate study was Industrial Organization and Regulation.

I have worked in the field of telecommunications regulation for approximately fifteen years. I was employed as an Economist in the Research Division of the Kentucky Public Service Commission for approximately one year. I began work at the New York Public Service Commission in 1987, and have held the positions of Telecommunications Tariffs and Rates Analyst, Telecommunications Policy Analyst, and Special Assistant to the Deputy Chair of the Commission. In these capacities, I performed economic and policy analyses of various telecommunications industry and regulatory issues, and formulated recommendations for Commission members and other decision-makers. Among other duties, I served as Staff team leader for issues of pricing and provisioning of unbundled network elements ("UNEs"), as Staff subject matter expert on Expanded Extend Link and Digital Subscriber Line-based services, and as a member of the Staff team that negotiated terms of Bell Atlantic - New York's Section 271 "Pre- Filing Statement". (This document served as the basis for Bell Atlantic's successful application before the FCC to provide in-region interLATA telecommunications services in New York). I was appointed Staff representative to the New York Telecommunications Exchange, a "blue-ribbon" panel convened to examine and coordinate that state's overall policies towards telecommunications, and served as the New York Staff representative to the Federal/State Open Network Architecture Joint Conference.

In 1993 I accepted the position of Special Advisor to Commissioner Barrett of the Federal Communications Commission ("FCC") on Common Carrier issues, and served in that capacity for approximately one year before returning to the Staff of the New York Public Service Commission. While at the FCC, I provided analyses and policy recommendations on a wide range of telecommunications issues, and functioned as liaison with the offices of other Commissioners, the Chairman and the FCC's Common Carrier Bureau. I prepared testimony, speeches and presentations for delivery before Congress and various regulatory and industry groups, and drafted for issuance informal and formal documents, including Separate Statements and Dissents from Commission Reports and Orders.

I have mediated disputes between telecommunications carriers, have chaired technical conferences and have participated in a number of industry collaborative meetings and workshops. I have testified in regulatory proceedings, have delivered speeches and presentations before industry and regulatory groups, and have co-authored two articles on telecommunications regulatory issues.

Q. **What is the purpose of your testimony in this proceeding?**

A. My testimony provides an overview and summary of Staff's position in this proceeding. First, I present Staff's overall evaluation of how the existing Ameritech Illinois ("AI," "Ameritech", or "the Company") alternative regulation plan has functioned. I then describe the two regulatory options which, in Staff's opinion, the Commission should consider in this proceeding. My testimony summarizes the major advantages and disadvantages of those options, and presents Staff's recommendations regarding those options. I then address aspects of the relationship between alternative regulation and the classification of services as non-competitive or competitive. Finally, I briefly summarize the testimony filed by each Staff witness in this proceeding, and describe how this testimony addresses major ten issues posed by the Commission for review in this proceeding. During the course of my testimony, I show the infirmity of several assertions made by Ameritech Illinois in its direct case.

Q. Are other Staff members sponsoring testimony in this proceeding?

A. Yes. In addition to me, there are thirteen Staff members testifying in this proceeding, as follows:

Staff Exhibit 2.0—Genio Staranczak sponsors Staff's proposed changes to the formula used in calculating rates in the annual filing.

Staff Exhibit 3.0—James Zolnierek addresses several economic issues raised by Ameritech Illinois witnesses and offers Staff's opinion on those issues.

Staff Exhibit 4.0—Judith Marshall addresses rate issues and potential methods of rate adjustments. In addition, Ms. Marshall addresses specific revenue requirement adjustments that Staff proposes to be excluded from the 1999 rate base calculations of Ameritech Illinois.

Staff Exhibit 5.0—Bill Voss provides Staff's adjusted 1999 rate base for Ameritech Illinois and shows the amount of revenues by which Ameritech Illinois exceeds that adjusted rate base.

Staff Exhibit 6.0—Dianna Hathhorn provides adjustments to the rate base calculation used in Staff Exhibit 5.0.

Staff Exhibit 7.0—Mary Everson provides additional input to the rate base calculation used in Staff Exhibit 5.0.

Staff Exhibit 8.0—Sam McClerren addresses historical retail and wholesale service quality results of Ameritech Illinois under the alternative regulation plan and recommends changes in the methodology used by the Company in calculating its service quality results.

Staff Exhibit 9.0—Cindy Jackson addresses Ameritech Illinois retail service quality results and recommends changes to the penalties that the Company would incur if service quality is removed from the Alternative Regulation Plan, or if it remains a part of the Plan.

Staff Exhibit 10.0—H.K. “Bud” Green addresses the Depreciation Rates and Fill Factors used by Ameritech Illinois in its development of Long Run Service Incremental Cost (LRSIC) as described in 83 Ill. Admin. Code Part 791.

Staff Exhibit 11.0—Janis Freetly calculates the Cost of Money that Ameritech Illinois should used in developing its Revenue Requirement for the 1999 Test Year.

Staff Exhibit 12.0—Joy Nicdao-Cuyugan addresses the testimony of Ameritech Illinois witness Avera and the impact of the Alternative Regulation Plan on the financial community’s view of Ameritech Illinois.

Staff Exhibit 13.0— Robert Koch addresses the performance of the Alternative Regulation Plan since its inception and recommends changes to the Plan that will provide benefits to both the Company and the consumers in the future.

Staff Exhibit 14.0—Mark Hanson addresses Ameritech Illinois’ rate rebalancing proposal, provides a Staff alternative to the Company proposal, and also provides a general rate design if the Commission decides to reinitialize rates or return the Company to rate of return regulation.

<u>Evaluation of the Performance of the Alternative Regulation Plan in Meeting Statutory and Regulatory Goals</u>

Q. **Please summarize Staff's assessment of the performance and results of the alternative regulation plan to date.**

A. As a general matter, Staff believes the alternative regulation plan has functioned well in several respects. It has, for example, eased some regulatory burdens for both Ameritech Illinois and the Commission. It has resulted in consumers realizing some benefits, and Ameritech realizing significant benefits. It has provided Ameritech Illinois incentives to invest in its telecommunications network in Illinois, and has provided the Company with increased pricing flexibility.

Staff will show, however, that the alternative regulation plan has not met several important goals and objectives for alternative regulation, and that it has not met all of the statutory requirements applicable to an alternative regulation plan. Perhaps most significantly, Ameritech Illinois has not maintained service quality levels under the plan, as required by statute. Additionally, Staff will show that Ameritech Illinois has structured its annual price cap filings to reduce consumer benefits under the plan. Staff is of the opinion that, because of these factors, the benefits that consumers have realized from alternative regulation have been reduced, while benefits to Ameritech Illinois have been increased significantly.

An additional factor not directly at issue in this proceeding, but which unquestionably bears upon the effectiveness of the Ameritech Illinois alternative regulation plan, is Ameritech's practices regarding reclassification of services to the competitive category. Since services classified as competitive are not subject to the plan, Staff believes the Commission must give consideration to the propriety of service reclassification if it is to craft an alternative regulation plan which will function well prospectively.

Q. **Ameritech Illinois witness Gebhardt states his understanding that review of the extent to which alternative regulation has met established statutory and regulatory goals would be "relatively routine", assuming no significant unanticipated negative plan impacts on customers and the state. (Ameritech Ex. 1.1 at 22). What is your assessment of this understanding?**

A. Mr. Gebhardt apparently inferred that the Commission did not intend to carefully scrutinize the functioning of this alternative regulation plan. Such an inference is not consistent with the fact that the Commission required this five-year review, which itself is not required by statute. Even a cursory examination of the requirements of this review supports the view that at the time the Commission authorized this plan, it intended to review its functioning in detail.

Even if one assumes, for the sake of argument, that Mr. Gebhardt's understanding is correct, review of the plan's performance in meeting statutory and regulatory goals should not be restricted to a "relatively routine" examination. As Staff demonstrates in this proceeding, there have been significant unanticipated negative impacts upon customers caused by the degradation in service quality over the last year. For this reason alone, setting aside any other considerations, a thorough review is in order.

Q. **Mr. Gebhardt's testimony purports to show that consumers have benefited from annual rate decreases under the alternative regulation plan, and he provides estimates of the dollar value of those rate reductions. What is Staff's opinion of Mr. Gebhardt's testimony in this regard?**

A. Consumers have realized rate reductions due to the working of the price cap plan. However, in Staff's opinion, such benefits are less significant than indicated by Mr. Gebhardt.

Mr. Gebhardt estimates the cumulative value to consumers of rate reductions under the plan, and compares that value to what he contends would have occurred under rate of return regulation. However, Mr. Gebhardt's point of comparison is invalid. He assumes the Commission would not have instituted any rate case over the time of the alternative regulation plan, which cannot be assumed. Given the performance of the macro economy, the rapid growth in demand for many telecommunications services provided by Ameritech Illinois, and the earnings performance of the Company over that time period, it is likely that the Commission would have instituted one or more revenue investigations that may have resulted in aggregate revenue and rate reductions. Staff witness Marshall (Staff Exhibit 4.0) addresses this issue in additional detail.

As Staff witness Koch shows, Ameritech Illinois has structured its annual price cap filings to reduce the benefits that consumers have realized from alternative regulation. To avoid this outcome in the future if the Commission extends alternative regulation, the Commission should adopt the recommendations contained in Mr. Koch's testimony (Staff Exhibit 13.0).

<u>Two Major Options</u>

Q. **You have stated that in Staff's opinion the Commission should consider two regulatory options in this proceeding. Please describe those options.**

A. First, the Commission may elect to extend alternative regulation for AI. If it does so, Staff recommends that the Commission modify several critical aspects of the current plan to ensure that the modified plan will satisfy statutory requirements and Commission policy objectives in the future. Staff proposed modifications also are designed to ensure that the failings of the current plan will not be repeated. If adopted by the Commission, these modifications should yield results consistent with statutory requirements and the Commission's policy goals and objectives. These modifications would permit the Commission to confidently extend alternative regulation for another four-year period, at which time another Commission review of the plan should commence (to be completed within one year). Since alternative regulation is a mechanism intended to facilitate the transition to effectively competitive local telecommunications markets, it is possible that by the time of the next review this mechanism no longer will be needed, and that transition effectively will have been achieved.

As a second, and inferior alternative, the Commission may rescind alternative regulation, and return Ameritech Illinois to Rate of Return ("ROR") regulation. Although I am not an attorney, I am advised by counsel that the Commission has the authority to rescind an alternative regulation plan. In Staff's opinion, this outcome would be undesirable for a number of reasons, and should, if possible, be avoided.

Q. **Please explain why Staff does not recommend returning Ameritech Illinois to rate of return regulation.**

A. Fundamentally, rate of return is not a very workable or desirable regulatory approach for a company such as Ameritech Illinois that provides some services in reasonably competitive markets, and others of its services in markets with little or no competition. Over the next few years, meaningful levels of competition may arise in most (not just a select few) of Ameritech Illinois's local telecommunications markets. Rate of return regulation cannot readily be adjusted to increasing levels of competition. For example, under ROR, the Commission cannot readily provide pricing flexibility where warranted, and limit pricing flexibility where competition is absent or ineffective at constraining prices to cost-based levels. Rate of return regulation also has a number of well-documented problems stemming from its diminished incentives for cost efficiency and technological innovation. Firms regulated under ROR also can be presented with strong incentives to attempt to cross-subsidize more competitive services with revenues from less competitive services.

In contrast, alternative regulation is a mechanism well suited to facilitate -- indeed it is designed to accommodate -- the transition from monopoly to competition. Alternative regulation plans can readily be adjusted to provide appropriate levels of pricing flexibility, and key parameters can be recalibrated periodically if necessary to ensure just and reasonable rates. Most fundamentally, alternative regulation yields significant benefits overall due to the fact that the regulated company has enhanced incentives to be cost efficient, technologically progressive, and innovative (both with respect to services provided and production processes). A properly designed and implemented alternative regulation plan can yield significant advantages over ROR regulation to all stakeholders involved. However, shortcomings in the design, implementation or execution of an alternative regulation plan can obviate those advantages, and the potential superiority of that plan can be compromised. Staff submits that the current Ameritech Illinois alternative regulation plan has had such shortcomings, but believes these can be remedied by the Commission in this proceeding.

Q. **Are there any advantages of ROR regulation that are particularly pertinent for the purposes of this proceeding, and of which the Commission should be mindful?**

A. Yes. A company subject to ROR regulation does not have strong incentives to reduce expenditures associated with maintaining or improving the service quality of noncompetitive services, as can be the case under alternative regulation. Thus, as a general proposition, regulators can expect that good service quality will be maintained under ROR regulation. Another major advantage would be that ROR regulation, accompanied by periodic revenue examinations and price adjustments as warranted, would ensure just and reasonable rates.

Q. **Are there potential disadvantages of alternative regulation for Ameritech Illinois that are particularly applicable to this proceeding?**

A. Yes. A Company under alternative regulation typically has strong incentives to be efficient and innovative, since this can result in increased earnings retained by the Company. It is well recognized, however, that these incentives include reducing costs associated with maintaining or improving service quality.

Similarly, alternative regulation incents the Company to minimize revenue and price reductions to consumers (when application of the price cap index (PCI) calls for such reductions), and maximize revenue and price increases (when application of the price cap index (PCI) calls for such increases). Staff witness Koch shows that Ameritech has acted on these incentives in its annual filings, and proposes changes that would reduce AI's ability to act on these incentives in the future.

Q. **What is Staff's overall assessment of Ameritech Illinois' proposed modifications to the current alternative regulation plan?**

A. Adoption of Staff's proposed modifications will bring the plan into compliance with statutory and Commission requirements. As various Staff witnesses show, the modifications proposed by Ameritech Illinois, on the other hand, would have the perverse result of increasing Ameritech Illinois' share of the benefits of alternative regulation at the expense of consumers. They would not bring the plan into compliance with the statute and Commission policy objectives for alternative regulation. Accordingly, these proposed modifications must be rejected.

Q. **Should the Commission choose simply to extend alternative regulation in its current form for some time period?**

A. No. The current plan has resulted in (or at the least has been associated with) statutorily unacceptable erosion of service quality levels. Moreover, Staff believes consumers have not realized the amount and degree of direct benefits from the plan initially envisioned by the Commission at the time of the plan's adoption.[1] Accordingly, Staff is of the opinion that the Commission should not extend the Ameritech Illinois alternative regulation plan in its current form, as to do so would be contrary to statute and Commission regulatory objectives. Several of the modifications proposed by Staff are intended to yield a plan that is more effectively "self-enforcing," so that it is less subject to potential abuse. Staff's recommendations would eliminate "loopholes" and ambiguities in the current plan.

<u>Service Quality</u>

Q. **Does Section 13-506.1 of the PUA address service quality requirements under alternative forms of regulation?**

[1] Staff witnesses Zolnierek and Koch discuss several actions taken by AI that have diminished the benefits received by consumers under the current plan.

A. Although I am not an attorney, I am advised by counsel that it does. Specifically, Section 13-506.1(b)(6) provides, in relevant part, that:

> [t]he Commission may approve a plan or modified plan and authorize its implementation **only if** the Commission finds after notice and hearing that the plan (or modified plan) at a minimum: . . . will **maintain** the quality and availability of telecommunications service (emphasis added).

Q. **Please summarize Staff's position regarding whether service quality has been maintained under the alternative regulation plan.**

A. Staff witnesses McClerren (Staff Ex. 8.0) and Jackson (Staff Ex. 9.0) demonstrate that some crucial aspects of service quality have not been maintained during the life of the alternative regulation plan. Their testimony demonstrates that under this plan Ameritech Illinois has failed to meet the "out of service greater than 24 hours (OOS>24)" service requirement, and apparently has chosen to pay penalties for failure to meet this requirement rather than expend resources rectifying the underlying causes of this failure. Mr. McClerren and Ms. Jackson also show that since consummation of the SBC/Ameritech Illinois merger, there has been significant erosion in service quality provided to Illinois customers, as measured by several indices. Ameritech Illinois' performance in meeting the benchmarks for out of service greater than 24 hours, and for installation of service in five days or less has deteriorated significantly.

Q. **What consequences attach to AI's failure to maintain service quality?**

A. Although I am not an attorney, I am advised by counsel that Section 13-506.1, (e) provides, in relevant part, that:

> [t]he Commission may rescind its approval of an alternative form of regulation if, after notice and hearing, it finds that the conditions set forth in subsection (b) of this Section can no longer be satisfied.

As noted above, the maintenance of service quality is specifically required by Section 13-506.1(b)(6). It is Staff's view that a central and crucial aspect of this proceeding is to examine the question of whether the requirements of Section 13-506.1(b)(6) can be satisfied going forward. Based on AI's service quality performance during the current plan, and the nature of its testimony concerning service quality submitted thus far in this proceeding, Staff considers it possible that the Commission might, with reason, be skeptical that AI can meet these requirements under alternative regulation. Staff believes that at an absolute minimum, the Commission should not extend the alternative regulation plan without establishing a more stringent, reliable and comprehensive set of measures (incentives and penalties) designed to ensure that Ameritech meets its service quality obligations under any future alternative regulation plan. [2]

In light of AI's failure to maintain service quality levels under the current plan as required by law and Commission policy, it is Staff's opinion that Ameritech Illinois

[2] The current plan clearly has failed to ensure that Ameritech Illinois met those obligations and therefore service quality incentives and penalties must be strengthened at a minimum to satisfy statutory requirements.

must address this issue responsibly and adequately as a prerequisite to the Commission extending the alternative regulation plan. This is particularly important since, of course, it is Ameritech Illinois that ultimately determines the level of service quality provided to its customers under alternative regulation. If, as AI asserts, alternative regulation is indeed a form of regulatory compact or bargain, then each party must meet its responsibilities under that compact for alternative regulation to succeed. [3] In Staff's view, it is incumbent upon Ameritech Illinois to provide sufficient evidence that, unlike the past results of the plan, an extension of alternative regulation for the Company will not result in a failure to maintain required levels of service quality.

Q. Should the Commission order rebates or refunds targeted to those customers most directly affected by poor service quality?

In Staff's opinion, imposition of retroactive rebates or refunds to address AI's failure to maintain required service quality levels is not desirable. Apart from the legal issue of whether such reductions would constitute retroactive ratemaking, as a policy matter such retroactive adjustments should be avoided for several reasons. They may have negative effects upon efficiency incentives, and they may constitute

[3] This is a fundamental reason Staff does not recommend returning to rate of return regulations and, as discussed below, why Staff does not prefer the option of reducing Ameritech Illinois's revenues to rate of return levels, even if coupled with an extension of alternative regulation.

a form of "double jeopardy" since the current plan was implemented with a given set of service quality penalties.

A. Should the Commission order a general revenue reduction to address the problem of poor service quality experienced by AI customers?

A "going-forward" revenue reduction avoids some problems associated with refunds or rebates, but this remedy could be reflected in rates extending well beyond the time service quality is restored to acceptable levels. Thus, the Company would be penalized even after a resolution of service quality shortcomings, unless the Commission were to rescind the rate reduction upon service quality restoration.

Staff does not favor rate changes that are short-lived since rate instability can cause uncertainty and/or confusion for consumers, AI's management, shareholders, and potential investors. However, variants of this approach could be implemented in a manner to avoid short-term rate fluctuations. For example, if it appears likely that operation of the alternative regulation formula would result in the PCI trending downwards (as it has over the life of the current plan), a general revenue reduction could be credited against a given PCI reduction (perhaps treated as an exogenous change factor) to avoid short-term rate fluctuations.

In Staff's view, however, it would be most preferable for the Company to voluntarily propose an adequate set of remedies. This could indicate AI's heightened appreciation of its service quality responsibilities under alternative regulation, and a commitment to meet those obligations under any extension of alternative regulation.

Q. Would Staff's position change if Ameritech Illinois were to restore service quality to acceptable levels prior to a Commission decision in this case?

This would not change the fundamental analysis presented here and in the testimony of other Staff witnesses. The fact remains that under the existing plan service quality has not been maintained as required. Therefore, any extension of the plan should recognize and properly account for this fact.

Q. **Ameritech Illinois asserts that any slippage in service quality under the alternative regulation plan is not attributable to alternative regulation, but would have or could have occurred under ROR regulation. Please respond.**

A. It does not appear that AI has provided any reliable evidence to support this contention. Even if the Company can do so, however, this argument should not be given any weight. The statute requires maintenance or enhancement of service quality levels under an alternative regulation plan. For whatever reason or reasons, the plan at issue here has not resulted in maintenance of adequate service quality.

Q. **Does Ameritech Illinois propose strengthening the penalty provisions in the current plan regarding service quality?**

A. No. AI's apparent position thus far in this proceeding is that there is no need to strengthen these penalty provisions. This occurs against a backdrop of multiple years of failure to meet all service quality benchmarks, and severe erosion of some critical elements of service quality over approximately the last year. It appears that AI has chosen to pay penalties for poor service quality rather than incur the costs necessary to maintain service quality levels, as required by statute. Since AI's earnings under the plan overall have been quite healthy, this failure cannot be justified.

Q. **Does the Commission's October 11, 1994 Order in Docket 92-0448/93-0239 (consol.) address service quality issues under alternative regulation for Ameritech Illinois?**

A Yes. On page 58 of that Order the Commission explicitly recognizes that Section 13-506.1(b)(6) of the statute requires the Commission to find that any alternative regulation plan adopted will <u>maintain</u> the quality and available of telecommunications services. On that same page, the Commission concluded that service quality standards <u>exceeding</u> those in effect at that time (in the

Commission's Part 730 rules) were necessary to "safeguard against erosion of service quality (emphasis added)."

Aggregate Revenue Reduction and Rate Reinitialization

Q. **Does Staff recommend that an overall revenue adjustment (reduction) occur if the Commission extends alternative regulation for Ameritech Illinois?**

A. Not at this time. While some amount of aggregate revenue reduction is justifiable for several reasons, Staff considers that its proposed modifications, in conjunction with an appropriate overall resolution of service quality issues, are sufficient to address the shortcomings of the current plan. In Staff's judgement, these modifications would help ensure just and reasonable rates if alternative regulation is extended for Ameritech Illinois. However, in the interest of providing the Commission a full record for consideration, Staff presents various options regarding the manner in which a general rate reduction may be effectuated, should the Commission deem this appropriate.

Q. What effect, if any, would a Commission finding in Docket No. No. 98-0860 that AI had improperly reclassified services as competitive have upon the alternative regulation plan?

A. One result of such a finding in Docket No. 98-0860 would be an effective revenue reduction of (at minimum) approximately $74 million. Any service determined by the Commission to have been improperly reclassified would be removed from the competitive category, and would once again be subject to the plan's price/revenue cap.

Q. Please summarize why Staff witness Voss, supported by the testimony of Staff witnesses Hathhorn and Everson, presents a calculation of AI's 1999 revenue requirements?

A. A calculation of revenue requirements is integral to the application of rate of return regulation. If the Commission elects to return the Company to ROR regulation, this analysis is central and should form the basis of the calculation of just and reasonable rates. The Commission also may wish to compare the results of alternative regulation with an approximation of what would have resulted if Ameritech had remained under ROR, to help assess how ratepayers have fared under the current plan.

Q. **Does this analysis apply if the Commission elects to modify AI's current alternative regulation plan and adopt that modified plan for future use?**

A. Potentially. In Staff's opinion, its proposed modifications to the current plan would be sufficient to ensure just and reasonable rates under an extension of the alternative regulation plan. However, if the Commission rejects Staff's analysis in whole or in part, it might choose to reduce AI's aggregate revenues (rate re-initialization) upon any extension of alternative regulation. The evidence placed in the record by Staff in this regard provides the Commission with a basis to determine the proper size of such a reduction.

Q. **Would rate reinitialization violate an implicit contract that may underlie the Ameritech Illinois alternative regulation plan, and thus exist between the Commission and the Company?**

A. No. Under other circumstances, this question could merit careful examination. However, to the extent such a contract or regulatory bargain exists, Ameritech Illinois previously has violated it by failing to maintain service quality at required levels.

Q. **Would an aggregate revenue reduction (and associated rate reinitialization) seriously undermine the Company's incentives for efficient operation and technological and service innovation?**

A. All other considerations being equal, an ROR-based earnings review with revenue reductions would reduce the strength and efficacy of these incentives. However, the size and significance of such reductions in incentives are a function of several factors. Suppose, for example, the Commission were to overlay periodic earnings reviews upon an alternative regulation plan, with retroactive rate adjustments for earnings above allowed ROR levels. If this was known and anticipated, efficiency incentives would be reduced to very low levels associated with stringent "cost plus" ROR regulation. In contrast, if the Commission overlaid this same ROR review upon an alternative regulation plan, but adjusted rates "going forward" rather than retroactively, the resultant impact on efficiency incentives would depend in large measure upon the frequency of this review. Earnings review every 2 years could virtually eliminate these incentives, while earnings review every 20 years would have much smaller negative impact.

If the Commission determines in the course of this review that rate reinitialization is appropriate, and does not order further periodic review of the plan, the reduction in efficiency incentives could be expected to be moderate. To the extent that alternative regulation is a transitional form of regulation intended to effectuate a transition to a fully competitive marketplace, the Commission may determine that further review is unnecessary or ought to be limited in scope. In this regard, Staff notes that by the Company's own assessments of the degree of competition in its markets (and the rapid increase in that competition), AI should expect that alternative regulation itself may be unnecessary at some point in the foreseeable future.

Service Reclassification

Q. Please summarize the impact that Ameritech Illinois reclassification of services from non-competitive categories has had on the alternative regulation plan over the last five years.

A. Service reclassification has resulted in the majority of AI's revenues now falling outside the operation of the current alternative regulation plan. While the propriety of AI's reclassification of service is a matter outside the present docket[4], this has worked to reduce the benefits realized by consumers from rate reductions associated with annual decreases in the PCI.

Q. What is the relationship between alternative regulation and a regulated carrier's ability to classify services as competitive?

Q. Speaking generally, only services provided in markets where the carrier can exercise market power are subject to the workings of the alternative regulation plan. Similarly, only services provided under market conditions that effectively limit the market power of such a carrier should be exempt from the oversight of the workings

[4] This is a matter at issue between AI and Staff in Docket 98-0860.

of the alternative regulation plan. The major exception to this is non-competitive services priced at cost, such as unbundled network elements, which may be outside the plan but subject to direct regulatory oversight.

Q. **Ameritech Illinois witness Gebhardt presents calculations of the company's earnings during the five-year life of the plan for the non-competitive service category. What significance does Staff attach to these calculations?**

Q. Although Staff has some reservations concerning AI's methodology, Mr. Zolnierek uses AI's methodology to provide the calculated rate of return earned over several years for the <u>competitive</u> services category. If services in this category are indeed provided under effectively competitive market conditions, one would expect that the relatively high level of earnings shown to exist by Mr. Zolnierek would attract significant competitive entry and the realized rate of return would begin to decline. There is no such discernible trend in AI earnings in this category.

<u>Summary of Staff Exhibits and Direct Testimony</u>

Q. **Please summarize Staff Witness Staranczak's testimony.**

A. Mr. Staranczak's testimony describes and recommends modifications to the current price cap formula including the inflation factor, the "X" factor and the "Z" factor. He recommends that the inflation factor be changed from the fixed weighted

GDPPI to the chain weighted GDPPI, which is now the most commonly quoted inflation measure for the economy as a whole. In addition, Mr. Staranzcak proposes that the other parameters of the formula be based on industry rather than Ameritech Illinois specific data, inasmuch as industry data yields the economically appropriate productivity differential and input price differential to use. Mr. Staranczak proposes that the "X" factor remain at 4.3% and include a 1% consumer dividend. He suggests no significant changes to the "Z" factor. Finally, Mr. Staranzcak recommends that the "X" factor not be adjusted downwards to take into account potentially more moderate growth in the economy. He demonstrates that more moderate growth in the economy will not adversely affect AI's ability to earn satisfactory returns, since the Company's productivity growth is less sensitive to the economy than other sectors.

Q. **Please summarize the testimony of Staff Witnesses McClerren (Ex. 8.0) and Jackson (Ex. 9.0).**

A. Mr. McClerren reports on two major service quality components: retail and wholesale service quality. Mr. McClerren discussed the manner in which the eight measures in the current alternative regulation plan were developed, as well as the Company's performance in comparison to those service quality measures. He shows that Ameritech has failed to meet both the "out of service > 24 hours" and "installation" measures, and has paid service quality penalties under alternative regulation, and is likely to be compelled to pay penalties to be paid pursuant to conditions imposed By the Commission pursuant to its approval of the SBC/Ameritech Merger, Docket 98-0555. With respect to wholesale service quality, Mr. McClerren describes the collaborative process resulting from Docket 98-0555, Condition 30, and the development of wholesale service quality standards in Illinois. He also notes that the wholesale standards may expire in October 2002, and recommends a set of key measures to be implemented in this proceeding, that would incent SBC/Ameritech Illinois Illinois' to provide adequate wholesale service quality after October 2002.

Ms. Jackson's testimony analyzes Ameritech Illinois's retail service quality pursuant to Section 13-506.1(b)(6) of the PUA, and responds to the testimony filed by Theresa Larkin (Ameritech Illinois Ex. 3.0) and David Gebhardt (Ameritech Illinois Ex. 1.1). She briefly discusses the service quality standards in 83 Illinois Administrative Code Part 730 ("Part 730") and Ameritech Illinois alternative regulation service quality standards in Docket No. 92-0448/93-0239. Ms. Jackson also reviews service quality complaints received by the Commission's Consumer Services Division, regarding AI's service quality, and proposes additional new service quality standards going forward. Her testimony also responds to that of Ameritech Illinois witness Gebhardt regarding Universal Service. Finally, Ms. Jackson offers the Commission alternative forms of penalties to address service quality in the transitional regulatory plan.

Q. **Please summarize Staff Exhibit 5.0, the Direct Testimony of Bill L. Voss, Staff Exhibit 6.0, the Direct Testimony of Dianna Hathhorn, and Staff Exhibit 7.0, the Direct Testimony of Mary H. Everson.**

A. Mr. Voss presents the Staff revenue requirement based upon a 1999 test year. If the Commission decides to re-initialize Ameritech Illinois' rates or if the Commission decides to return Ameritech Illinois to rate of return regulation, this revenue requirement provides a calculation of the Company's test year operating revenues. The Staff revenue requirement incorporates the adjustments proposed by Ms. Hathhorn and Ms. Everson.

Q. **Please summarize the Direct testimony of Janis Freetly, Staff Exhibit 11.0 in this proceeding.**

A. Ms. Freetly presents Staff's analysis of Ameritech Illinois' capital structure for the year ended December 31, 1999, and its weighted average cost of capital. Ms. Freetly' recommends an overall rate of return which should be used in computing AI's revenue requirement in the event that the Commission orders rate re-initialization or a return to rate of return regulation as part of this proceeding. Ms. Freetly also responds to a portion of the supplemental direct testimony of AI witness David H. Gebhardt and the direct testimony of AI witness Roger G. Ibbotson.

Q. **Please summarize the direct testimony of Staff witnesses Koch and Hanson.**

A. Mr. Koch's testimony, Staff Exhibit 13.0, discusses the workings of the service baskets in the alternative regulation plan. His testimony is divided into four parts. First, Mr. Koch describes the nature of the price cap plan currently in effect, including calculation of the PCI and API. Second, he discusses the performance of the plan since its inception, detailing problems raised by AI's annual filings as well as the performance of the plan in reducing rates. Mr. Koch shows that, under the plan, in its current state, rates for most services cannot significantly change. Third, Mr. Koch's testimony demonstrates that AI's recommendations, if adopted, would have significant negative impacts on residential customers and the Commission's ability to regulate noncompetitive services on a going-forward basis. Finally, Mr. Koch recommends changes to the plan on a going-forward basis that would benefit customers in Illinois and improve the ease of administering the plan.

Mr. Hanson (Staff Exhibit 14.0) examines the rate rebalancing proposal sponsored by Mr. Van Lieshout, and recommends rejection of this proposal for several reasons. Mr. Hanson also provides an alternative rate rebalancing proposal, in the event the Commission determines that rate rebalancing is necessary. Rate design proposals to accompany any aggregate revenue reduction determined by the Commission are also set forth in this testimony.

Q. Please summarize the Direct testimony of James Zolnierek (Staff Exhibit 3.0) in this proceeding.

A. Mr. Zolnierek addresses the shortcomings in the competitive analysis of Dr. Harris (Ameritech Illinois Exhibit 4.0). He observes that Dr. Harris did not consider market or pricing power in his analysis, and presents examples from Ameritech's own testimony that indicate that Ameritech Illinois retains significant market power in some of its local exchange and exchange access markets. Mr. Zolnierek also addresses economic pricing principles surrounding rate design. He points out that efficiency and equity should be guiding principles behind any regulatory change, and demonstrates that Ameritech's rate rebalancing proposal is defective on the basis of both criteria. Finally, Mr. Zolnierek proposes reporting requirements, noting that information supplied by Ameritech in this proceeding has been valuable in evaluating the effectiveness of the alternative regulatory plan.

Q. **Please summarize the Direct Testimony of Staff witness Nicdao-Cuyugan.**

A. Ms. Nicdao-Cuyugan's testimony responds to assertions made by Ameritech Illinois witness Dr. William Avera regarding investor perceptions of AI. She concludes that Dr. Avera's opinions of investor perceptions of Ameritech Illinois are largely unfounded and irrelevant for the purposes of this proceeding.

Q. The Commission specifically designated the following 10 issues for review in this proceeding:

1. Does the inflation index and the manner in which it is applied provide an adequate reflection of economy-wide inflation?

2. An assessment of productivity gains for the economy as a whole, for the telecommunications industry to the extent data are available, and for Illinois Bell during the period that the alternative regulatory framework has been in place, and whether the adopted general adjustment factor should be modified.
3. Whether the adopted monitoring and reporting requirements should be retained or adjusted.
4. The extent to which Illinois Bell has modernized its network and additional modernization plans for the near term.
5. A listing of all services in each basket and a report of the cumulative percentage changes in prices for each service during the period the price cap mechanism has been in effect.
6. A listing of any services which have been withdrawn during the period.
7. A listing of all services which have been reclassified as competitive or noncompetitive during the period.
8. A summary of new services which have been introduced during the period.
9. Information regarding any changes in universal service levels in Illinois Bell's service territory during the price cap period.
10. Whether, and the extent to which, the adopted regulatory framework has met each of the established statutory and regulatory goals?

Please identify which Staff witnesses addressed these issues.

A. Mr. Staranczak addresses issues 1) and 2). Judith Marshall addresses item 3). Items 4) – 8) designate information that must be and has been provided by Ameritech Illinois. Robert Koch addresses these issues. Staff witness Cindy Jackson addresses issue 9), and several Staff witnesses address issues related to item 10) at various points in testimony.

Q. Does this conclude your testimony?

A. Yes, it does.